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COUNSELOR'S CORNER

Bitcoins & Banking:

Bona Fide or Balderdash?

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"Stay away. Bitcoin is a mirage. . . The idea that it has some huge intrinsic value is just a joke in my view." —Warren Buffett on CNBC, March 14, 2014.[1]

CONSIDERING THE WEIGHT OF MR. Buffett's view, this could be a very short article. Are there any reasons bankers should spend time thinking about Bitcoin? Short answer: Bankers probably have several more pressing challenges that need attention. Longer answer: There are reasons to consider the impact this technology may have on banks in general in the medium-term future.

What is Bitcoin?

Bitcoin is an open-source software system designed to create and manage units of a virtual currency called Bitcoins. Bitcoins have no physical presence and no intrinsic value. They are considered a "cryptocurrency" because the system depends on cryptography. The system is decentralized (has no central issuing authority) and is designed to allow online payments directly from one party to another without going through a bank. Bitcoins are created as a reward for entities that use their computers to support the system ("miners"). Creation occurs at a steady rate that decreases over time and will cease when 21 million Bitcoins have been created some decades from now. Bitcoins can be acquired by "mining" them, purchasing them (e.g., at a Bitcoin exchange), or accepting them as payment.

Bitcoin transactions are dependent upon the use of cryptographic public keys and private keys. The private keys must be kept secret. Secrecy can be maintained by storing the private key on paper, on an external storage device, or in a software "wallet." Like cash, if the security of a bitcoin owner's private key or wallet is compromised, the owner's bitcoins can be stolen. Bitcoins also can be lost if the private key is lost.[2]

A key feature of Bitcoin technology is a public ledger of all transactions known as the "blockchain."[3] The blockchain is central to the proper functioning of the Bitcoin network. The blockchain is where miners, by consensus, confirm transactions by packing them into blocks that fit strict cryptographic rules. This system verifies that bitcoins are actually owned by the spender and prevents double spending. Bitcoin transactions are irreversible.

Is Bitcoin legitimate?

Because they had some initial popularity in supposedly anonymous transactions to purchase illegal drugs (among other things) at illicit websites like Silk Road (closed by the FBI in 2013), bitcoins have had an air of illegitimacy. Following the closure of Silk Road, however, the FBI reportedly acknowledged to the Senate Homeland Security and Government Affairs committee that virtual currencies offered "legitimate financial services" although they were obviously subject to abuse. As some mainstream merchants have started to accept bitcoins[4] and as they become the subject of various types of regulatory review,[5] Bitcoin has improved its aura of legitimacy. This question of legitimacy will probably become moot, for Bitcoin or some other virtual currency, the day the biggest online retailers begin to accept it for payment.

Doesn't Bitcoin have a lot of issues?

Yes, here is just an introductory sampling: (1) Bitcoins have no intrinsic value, no legal backing, and a value that fluctuated substantially compared to the dollar from zero to more than $1,100 (at the time of this writing, they are in the range of $460);[6] (2) Bitcoin is almost entirely unregulated (which may be a virtue to some,[7] is almost certainly not a good thing for consumers,[8] and is not necessarily a great thing for bankers);[9] (3) There appears to be real security and/or management problems at some exchanges—Mt. Gox in Japan is the most noteworthy example (now in bankruptcy, it reportedly lost some $470 million in bitcoins), but exchanges in Canada, China, and Palau have also recently been closed and/or have suffered losses from hacking; (4) In March of this year, the IRS issued guidance indicating that bitcoins and other virtual currencies would be treated like property, meaning, among other things, that payments may result in tax events if the property purchased exceeds the payor's basis in the bitcoins used (thus creating a number of potentially serious recordkeeping and other issues for payors); and (5) Like any other technology, Bitcoin has competitors and could well fall victim to the next newer and better platform.

Why should bankers be interested in Bitcoin or technologies like it?

1. Bitcoin technology is the end of banking as we know it.

This may be overstated, but some of Bitcoin's proponents would like to think otherwise.[10] As a system specifically designed to cut banks out of the payment process, this technology obviously does present some level of threat in an area that has historically been dominated by banks. All other things being equal, Bitcoin's low transaction costs could have obvious appeal to merchants.[11]

Bitcoin transactions are also same-day transactions (usually confirmed within minutes). U.S. banks have thus far been slow to increase payment speed to this level (although the wire system is obviously available for a price). Banks may be nudged to be faster by the Federal Reserve System.[12] Bitcoin transactions also may have some data breach advantages inasmuch as they do not contain identifying personal information, something that has obviously become an increasingly important issue for banks and merchants.

2. Bank customers may have bitcoins.

Banks' customers may hold bitcoins or other virtual currencies as either a store of value for making payments or as an investment. The total value of bitcoins currently in worldwide circulation is in the neighborhood of $6 billion (at their current valuation). Therefore, a low likelihood exists that any particular bank (especially a community bank) will soon find it necessary to deal with a deluge of customers with significant Bitcoin wealth. A banker could nonetheless occasionally find it necessary to have a basic understanding of virtual currency in order to evaluate a customer's claimed wealth or money-laundering risks. Requests to use bitcoins as collateral also could present significant issues, not the least of which would be perfection, control, and valuation. In the coming years, will banks need to have an established response for customers who want to pay the bank in Bitcoins or who want the bank to act as a custodian or trustee for the customer's bitcoin holdings?

3. Potential new commercial customers may be running a Bitcoin business.

The irony of Bitcoin businesses (like exchanges) needing bank accounts is probably not terribly amusing to those businesses that currently find it difficult to locate a bank that will take their business.[13] FinCEN's guidance on virtual currency businesses reportedly did not help much in this regard (even though it indicated that mere users of virtual currencies were not money services businesses)[14] nor did the FDIC's guidance on exercising care when dealing with payment processors.[15] Like the businesses themselves, bankers may find it difficult and unprofitable to evaluate a business that presents money laundering, money services business, money transmitter, and risky business diligence questions, not to mention the normal difficulties associated with on-boarding a new customer that has a start-up business dependent on a relatively new technology.

4. Bitcoin or a succeeding technology may present business opportunities for banks.

Bitcoin entrepreneurs of course believe that banks are either squandering the Bitcoin opportunity or jumping on the bandwagon, or that Bitcoin will be part of the new global banking order.[16] While these beliefs may be open to question, some reports indicate that big banks are already at least evaluating the Bitcoin phenomenon and perhaps even evaluating the technology as a potential business opportunity for themselves. Bank of America was reported to have

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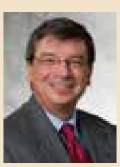
released a report in December that indicated Bitcoin could become a major means of payment for ecommerce and a serious competitor to traditional money transfer providers.[17] Wells Fargo reportedly has launched a group to examine how the bank might safely offer Bitcoin services or bank products to virtual currency entrepreneurs and also has published the excellent "Bitcoin 101: A Primer."[18] UBS also has studied and released a report on Bitcoin,[19] and BMO is reported to potentially be open to one day being an intermediary for Bitcoin transactions.[20] In December, the Economist reported that Chase had filed a patent application for something that "sounds rather like" Bitcoin.[21] There is already a Sharia-compliant Islamic Bank of Bitcoin (or at least a website for it).

5. The future is coming; Bitcoin or a succeeding technology may well be part of it.

If the attention already being paid to Bitcoin and the businesses springing up around it is not enough, the real future of this technology may be in exploitation of the blockchain technology for ancillary or next-generation products such as "colored coins" that carry some secondary value like a record of ownership of a stock or asset, digital (potentially self-executing) contracts, or a notary-like "proof of existence" service to prove a particular document existed at a certain point in time.[22] These sorts of things are clearly further off in the future, but not necessarily the far distant future that today's bankers will never see. ◗



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[1]For an alternate view: "The historical track record of old white men crapping on new technology they don't understand is at, I think, 100%." Venture capitalist Marc Andreessen, quoted in "Bitcoin Battle: Warren Buffett vs. Marc Andreessen" on Forbes.com, March 26, 2014. For a more neutral take, see "Bitcoin: Both Buffett and Andreessen are Right," on CNN.com, March 27, 2014.
[2]One user is reported to have lost millions of dollars' worth of bitcoins when he discarded a hard drive containing his key.
[3]The blockchain can be viewed at http://blockchain.info/, where a visitor can watch transactions occur, view the transactions in blocks, see the rewards to miners and look at the transaction history for particular addresses (kind of like looking at someone's wallet or checkbook).
[4]For example, Overstock.com, Reddit, Zynga, Wordpress, OKCupid, Tesla, and Virgin Galactic.
[5]For example, FinCEN and IRS guidance referenced later in this article.
[6]See bitcoincharts.com for more detailed information. It also has been suggested that the fact that bitcoin holdings are concentrated in the hands of a relatively few owners might be reason for concern about market manipulation.
[7]Especially our libertarian friends, who may like the fixed money supply aspect of the system.
[8]For example, unlike credit card transactions where cardholders have federal protections and card association chargeback machinery at their disposal, Bitcoin transactions are irreversible in the event of unauthorized use.
[9]China appears to have solved this problem by banning Bitcoin.
[10]Even outside the ardent venture capitalists' and enthusiastic first-adopters' ranks lies some degree of the dramatic. For example, in a recent presentation on Bitcoin, a vice president at the Federal Reserve Bank of St. Louis, under the heading "The Evolution of Money," made the dire prediction that traditional institutions will be forced to "adapt or die." (And we know something is wrong with that statement since money does not evolve, it is intelligently designed!)
[11]This could change to some extent when miners' rewards are decreased or eliminated and replaced with fees.
[12]See "How Big Banks Killed a Plan to Speed up Money Transfers," American Banker, November 13, 2013 (a revised plan has since been proposed by NACHA), and "Message to Banks: Speed Up Payments or Fed Will Take Charge," American Banker, November 13, 2013 (another paper on this topic is expected to be released by the Fed in the second half of 2014).
[13]See "Bitcoin Companies and Entrepreneurs Can't Get Bank Accounts," Forbes.com, November 15, 2013, and "Banks Mostly Avoid Providing Bitcoin Services," WSJ.com, December 22, 2013.
[14]Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies, FIN-2013-G0001 (March 18, 2013).
[15]Payment Processor Relationships Revised Guidance, FIL-3-2012 (January 31, 2012) and FDIC Supervisory Approach to Payment Processing Relationships with Merchant Customers that Engage in Higher Risk Activities, FIL-43-2013 (September 27, 2013).
[16]"Banks Squander Opportunity in Bitcoin," American Banker, November 18, 2013; "Big Banks Jumping on Bitcoin Bandwagon," Marketwatch.com, March 7, 2014; "Bitcoin Will be Part of the Global Banking Order, says Circle CEO," Gigaom.com, April 7, 2014.
[17]"Bitcoin Valued at $1,300 by Bank of America Analysts," Forbes.com, December 5, 2013 (obviously somewhat dated thinking given the value in the headline).
[18]"Wells Fargo Organizes Meet to Discuss Bitcoin Rules: FT," Reuters.com, January 14, 2014; "Bitcoin 101: A Primer" and "Foreign Exchange Research Special Edition," Wellsfargomedia.com, March 7, 2014.
[19]Bitcoins and Banks: Problematic Currency, Interesting Payment System," UBS.com, March 28, 2014.
[20]"BMO Open to Bitcoin if Virtual Currency Is Regulated, Reliable, says CEO Bill Downe," Financialpost.com, April 2, 2014.
[21]"JPMorgan Jumps in," Economist.com, December 11, 2013; but see "You Should Probably Ignore That 'JP Morgan Bitcoin' Patent – It's Over a Decade Old," BusinessInsider.com, December 10, 2013.
[22]"Why Bitcoin Matters for Bankers," American Banker, March 28, 2014.